

STATE OF IOWA  
DEPARTMENT OF COMMERCE  
UTILITIES BOARD

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| IN RE:<br><br>MIDAMERICAN ENERGY COMPANY | DOCKET NO. RPU-02-2 |
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**ORDER OVERRULING AND DENYING OBJECTIONS AND  
APPROVING SETTLEMENT**

(Issued November 8, 2002)

**PROCEDURAL BACKGROUND**

On March 15, 2002, MidAmerican Energy Company (MidAmerican) filed with the Utilities Board (Board) proposed gas tariffs, identified as TF-02-115 and TF-02-116. In TF-02-115, MidAmerican proposed a temporary increase that would produce additional revenue of approximately \$20.4 million. In TF-02-116, MidAmerican proposed a permanent annual revenue increase of approximately \$26.6 million, or an overall annual revenue increase of 4.3 percent. On April 3, 2002, the Board docketed the proposed temporary and permanent rate increases as Docket No. RPU-02-2.

The Board, on June 12, 2002, issued an order approving a temporary rate increase of \$13,823,286. The temporary rate increase was calculated based upon an overall rate of return of 9.394 percent and a return on common equity of 11.3 percent.

On July 15, 2002, all parties to this proceeding, except for Keith E. Meyer, filed a "Settlement Agreement" proposing to settle all outstanding issues with regard to MidAmerican's permanent rate increase request. The settlement, if approved, would allow MidAmerican to increase natural gas rates by approximately \$17,746,034.

On August 14, 2002, Mr. Meyer filed his protest of the settlement as required by 199 IAC 7.2(11)"c." The Board issued an order shortening time for reply comments, and on August 16, 2002, MidAmerican and the Consumer Advocate Division of the Department of Justice (Consumer Advocate) filed reply comments. MidAmerican and Consumer Advocate supported the "Settlement Agreement" and contended that the settlement meets all of the requirements of 199 IAC 7.2(11) and none of the issues raised by Mr. Meyer rose to the level of being an issue of material fact for which a hearing was required.

On August 30, 2002, the Board issued an order finding that Mr. Meyer had raised two issues of material fact with regard to the settlement. The Board set the two issues for hearing to be held on September 16, 2002. The hearing was held as scheduled and Mr. Meyer cross-examined MidAmerican witnesses Dr. James Vander Weide and Mr. Gregory Schaefer. Briefs were filed by Mr. Meyer and MidAmerican, and Archer Daniels Midland Co. (ADM) and Tyson Foods, Inc. (Tyson), filed post-hearing comments in lieu of a brief. On October 17, 2002, Mr. Meyer filed an objection to the comments of ADM and Tyson.

The two contested issues raised by Mr. Meyer and considered at the hearing are the appropriate return on common equity to use in setting permanent rates for MidAmerican and the rate disparities between the east and west zones on MidAmerican's system. Mr. Meyer did not present a witness on either issue. The two contested issues and the settlement will be addressed below.

ADM and Tyson in their comments stated that Mr. Meyer developed no competent evidence on cross-examination which showed that the settlement was contrary to law or the public interest. The two companies stated further that the settlement is a compromise among the parties in which each party compromised and that Mr. Meyer did not provide any basis in law or fact to deny the settlement.

## **CONTESTED ISSUES**

### **1. Rate Disparities**

Mr. Meyer in his objection to the settlement raised the issue of the legality of rate disparities between MidAmerican's east and west zones. In his brief Mr. Meyer again raised this issue. Mr. Meyer did not address any of the specific rate differentials in his objection, at the hearing, or in his brief.

MidAmerican supports the rate design that was agreed to in the settlement. MidAmerican argues in its brief that the settlement shows considerable movement toward rate parity and is a reasonable effort to mitigate the adverse effect of a complete movement to total parity. MidAmerican points out that the settlement (1) reduces the rate differentials that existed before this proceeding, (2) limits increases

to residential customers to no more than 6.75 percent of test period billed revenues to reduce rate shock, (3) leaves prices for all volumes over 1,000 therms the same for the medium general service group, and (4) reduces the average delivery charge difference between east rate 90 and west large volume transportation rate by 36 percent, while limiting west large volume increase to 20 percent. MidAmerican concludes that the Board has the authority to balance other policy considerations such as rate shock with rate consolidation.

At the hearing on September 16, 2002, MidAmerican witness Gregory C. Schaefer testified that MidAmerican agreed that the rates in the east and west zones should be the same for the same service and that MidAmerican had a plan to remove the rate disparities. Mr. Schaefer testified that the rates in the east and west zones pay for the same service and are based upon the same class cost of service. Mr. Schaefer testified that MidAmerican had no fixed date to eliminate the rate disparities and complete elimination of the disparities would depend on the total overall revenue requirement in the next rate case and the rate increase for individual customers. Mr. Schaefer also testified that the settlement eliminated over one half of the disparity and that the parties to the settlement agreed that further movement was not acceptable due to the increases that would result to some customers, "rate shock."

The evidence shows that MidAmerican's east and west gas pricing zones have separate customer classifications, rate levels, and rate designs, based on the rates approved for Iowa-Illinois Gas and Electric Company and Midwest Gas

Company prior to their merger into MidAmerican Energy Company approved by the Board in 1995. The Board has twice before approved rates that reduced the rate differentials between the east and west zones but has not required total parity. In Docket Nos. RPU-01-3 and RPU-01-5, the Board found that “Bringing together various rate zone prices raises not only cost of service issues, but also policy issues such as rate shock.” “Order Approving Settlement With Modifications,” MidAmerican Energy Company, Docket Nos. RPU-01-3, RPU-01-5, (issued 12/21/01).

Some of the current differences between the two zones are still significant. For example, test year rates in this case show east zone residential customers paid non-gas rates that were 17 percent lower than average, while west zone residential customers paid non-gas rates that were 11 percent higher than average.

MidAmerican has proposed to bring the east and west zone rate disparities into parity over time instead of proposing to eliminate the disparities in this docket. The settlement makes a substantial movement to rate parity and the settlement rate design classifies customers according to MidAmerican’s east zone classifications. The settlement will produce uniform class rates for the Large-Demand-Metered class and Seasonal Service class. The settlement will reduce non-gas zone differentials for other classes as follows:

| <u>Rate</u>     | <u>Zone</u> | <u>Current</u> | <u>After settlement</u> |
|-----------------|-------------|----------------|-------------------------|
| Residential     | East        | (17.0%)        | (6.9%)                  |
|                 | West        | 11.0%          | 4.5%                    |
| General Service | East        | (5.8%)         | 0.9%                    |
|                 | West        | 3.1%           | (0.5%)                  |

|                       |              |                  |                  |
|-----------------------|--------------|------------------|------------------|
| Large General Service | East<br>West | 17.9%<br>(16.1%) | 11.1%<br>(10.0%) |
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The Board finds that as a matter of policy customers who receive the same service based upon the same cost of service should, unless there are other considerations, be charged the same rates. The function of the Board in a ratemaking proceeding is to establish a reasonable and just amount to be paid for the utility's goods and services. Iowa-Illinois Gas and Electric Company v. ISCC, 412 N.W.2d 600, 605 (Iowa 1987). In determining what are just and reasonable rates, the Board may select a middle ground within a zone of reasonableness, and whether a decision is within the zone of reasonableness depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant factors. Id., at 608, 610. A rate fixed by the Board for a public utility is presumed valid and reasonable and the person challenging the validity of a rate has the burden of proving that the rate is unreasonable, confiscatory, excessive, or violative of constitutional immunities. City of Des Moines v. ISCC, 285 N.W.2d 12, 16 (Iowa 1979).

When making decisions concerning the specific rates to charge different classes or customers within a class, the Board primarily looks to cost causation and allocates costs to customer classes based upon the result of that inquiry. Other factors though can influence the ultimate rates to be charged individual customers. After considering the appropriate allocation of costs to those who cause the costs, the Board then considers the efficient use of the service, social policies regarding use

of a service, and the effect a significant increase in a rate will have on individual customers.

Since MidAmerican is providing the same service to both east and west zone customers but at different rates, the rate differentials must be based upon a factor other than cost causation. Here that factor is the effect a complete move to parity would have on individual customers. The Board finds that the proposed settlement makes a significant move toward parity and, as shown in the chart above, complete parity would involve significant increases in rates for certain customers. Rate parity is the ultimate goal, but the effect of rates on customers must be taken into account as the Board reaches this goal. In this instance, the Board finds that the settlement provides a reasonable movement toward elimination of the rate disparities between the east and west zones. Mr. Meyer's objection to the rate disparities that are reflected in the settlement is overruled and denied.

The Board, though, considers the elimination of the rate disparities to be a significant issue that needs to be addressed in MidAmerican's next general rate application. The rate disparities have existed since 1995, they are not cost based, and there needs to be certainty that they will be eliminated. The significant changes in rates that result from the approval of the rate design changes in the settlement should be absorbed by the next rate case. The full elimination of the rate disparities in the next case will bring the two zones into parity and have customers paying the same rate for the same service.

## **2. Return On Common Equity**

Mr. Meyer in his objection to the settlement contended that the return on common equity of 10.75 percent in the settlement is excessive. He cited to a statement of Warren Buffet, CEO of Berkshire Hathaway Inc. and principal shareholder of MidAmerican's parent, that 11 percent returns on common equity were high. Mr. Meyer also contended that MidAmerican witness Dr. James Vander Weide did not use a correct set of comparative companies in his Discounted Cash Flow (DCF) analysis and did not adequately address non-linear changes or structural breaks in his risk premium analysis. Mr. Meyer questioned Dr. Vander Weide extensively on cost of equity concerns at the hearing. Mr. Meyer did not discuss or argue any of these concerns in his brief.

MidAmerican supported the return on common equity reflected in the settlement of 10.75 percent. MidAmerican, in its brief, argues that Dr. Vander Weide is an expert in the field of developing returns on equity for utilities and that his three methodologies are very commonly accepted methodologies in the financial community for estimating the cost of equity. MidAmerican states that most of Mr. Meyer's cross-examination consisted of questions concerning how the methodologies worked and what inputs were logical to use and did not raise any questions about the testimony given by Dr. Vander Weide.

MidAmerican points out that movements in capital markets since Dr. Vander Weide filed testimony would lower cost of equity estimates by 10 to 15 basis points



below the 12.6 percent supported by Dr. Vander Weide's analysis. Since the 10.75 percent return in the settlement is below Dr. Vander Weide's analysis, MidAmerican states that one can logically conclude that the settlement return is reasonable in light of the record as a whole.

The Board found that a return on common equity of 11.3 percent was reasonable for temporary rates. This was based upon economic information available at the time the order was issued. The return on common equity reflected in the settlement is 35 basis points below that approved by the Board for temporary rates. The Board finds this is reasonable since an update of the risk premium analysis based upon October 2002 A-rated utility bond rate of 7.17 percent, from Mergent's Bond Record, October 2002, p. 60, and a risk premium range of 250 to 450 basis points produces an equity zone of reasonableness from 9.67 percent to 11.67 percent. The 10.75 percent falls well within this range.

The Board finds that Mr. Meyer's questions of Dr. Vander Weide's analysis and Dr. Vander Weide's recommendation of 12.6 percent return on common equity did not produce any evidence to refute the reasonableness of the 10.75 percent that is used in the settlement. The Board finds that the proposed settlement is based upon a reasonable return on common equity of 10.75 percent. Mr. Meyer's objection to the settlement return on common equity is overruled and denied.

## **SETTLEMENT**

Since the Board has overruled and denied the two objections of Mr. Meyer, it must look to the terms of the settlement to determine whether the settlement is reasonable in light of the whole record, consistent with law, and in the public interest. 199 IAC 7.2(11); Iowa Code § 17A.12(5).

The revenue deficiency proposed by MidAmerican in its application for a permanent rate increase was \$26,645,000, with a test year total revenue requirement of \$706,114,000. The Board approved a temporary rate increase of \$13,823,286, with the revenue requirement not to exceed \$696,981,107. The settlement rates reflect a revenue deficiency of \$17,746,034 and the test year revenue requirement of \$699,612,467. Although the permanent increase reflected in the settlement is above the amount approved for temporary rates, it is significantly below the initial request. Some of the difference between the temporary rates and the settlement rates can be attributed to issues where the Board found that amounts should not be included in temporary rates since they were not known and measurable at the time temporary rates were set.

Additionally, the Board makes the following findings with regard to the cost of capital, rate base, income statement, and class cost of service and rate design reflected in the settlement.

1. The overall rate of return used by the settlement is 9.101 percent and reflects the 10.75 percent return on common equity found to be

reasonable above. The settlement reflects the capital structure balances and senior capital cost rates used for setting temporary rates approved by Board order issued June 12, 2002. The capital structure and cost rates for senior capital are almost identical to the ones used in setting temporary rates. The Board finds that it is reasonable to use this capital structure and senior capital cost rates for setting permanent rates.

2. Most of the rate base adjustments were settled using the adjustments proposed in MidAmerican's original filing. The settlement rate base adjustments total \$232,451 less than originally filed. The difference is the result of not including the state tax normalization adjustment originally proposed. The settlement amounts for the rate base are reasonable.

3. Most of the income statement issues were settled using the adjustments proposed by MidAmerican. The total after tax adjustment to net income in the settlement is a \$2,270,203 increase in Operating Income. This compares to the original filing which proposed a \$339,256 increase in Operating Income.

The largest single adjustment to income is for a competitive pricing adjustment. The company had originally proposed an adjustment decreasing test year income by \$387,000. This settlement adjustment increases test year income by \$833,000. Although the settlement does not provide the details of

any adjustments, the overall approach and settlement amounts are reasonable.

4. The settlement compromise for class-cost-of service resolves the issue of whether distribution mains should be classified and allocated only according to peak demand and throughput, or whether a portion should be classified and allocated as customer cost based on a theoretical "minimum system." The Board has accepted both approaches at different times in past cases. The settlement states that MidAmerican supported use of a "minimum system" and Consumer Advocate opposed it. The settlement compromise takes a simple average of the results from both approaches. The class cost-of-service changes reflected in the settlement are somewhat modified by the settlement rate design. This result has been approved by the Board in past rate cases, where class cost-of-service is used as a guide rather than the sole determinant of rate design changes. The Board finds that the class cost-of-service agreed to by the parties in the settlement is reasonable.

5. The settlement billing determinants reflect one-half of the adjustment for "declining use per customer" originally proposed by MidAmerican. The Board denied this adjustment in temporary rates, reserving final judgment for the full case. The Board finds that the billing determinants reflected in the settlement are reasonable.

6. The rate disparities that are reflected in the settlement are considered above as a contested issue. The rate design changes agreed to in the settlement demonstrate that significant movement has been made to remove east-west zone rate design differences. The Board will direct MidAmerican to eliminate those disparities in the next rate case.

7. The settlement reflects that MidAmerican projects expenditures of \$6,648,629 for remediation of former manufactured gas plant (FMGP) sites in 2002, \$6,8845,878 in 2003, \$5,287,022 in 2004, \$2,025,000 in 2005, and then \$330,000 in the years 2006 through 2011. At the hearing, the parties agreed that the settlement included remediation expenditures of \$4.3 million in rates. MidAmerican indicated that the difference between the \$4.3 million and the projected expenditures would be made up with insurance recoveries. MidAmerican and Consumer Advocate agreed that the principles of the settlement concerning the use of insurance recoveries in Docket No. RPU-91-5 are still in full force and effect and are not modified by the settlement in this docket.

Since the insurance recoveries and the remediation associated with expenditures of those recoveries are covered by the settlement agreement in Docket No. RPU-91-5, the Board will address any issues regarding those recoveries and expenditures in that docket.

### **CONCLUSION**

The Board, after examining the complete record of this proceeding, finds the proposed settlement to be reasonable, consistent with law, and in the public interest. The settlement will be approved. MidAmerican will be required to file compliance tariffs consistent with the settlement within 20 days of the date of this order.

### **ORDERING CLAUSES**

#### **IT IS THEREFORE ORDERED:**

1. The proposed tariffs filed by MidAmerican Energy Company on March 15, 2002, identified as TF-02-115 and TF-02-116, and made subject to investigation as part of this proceeding, are declared to be unjust, unreasonable, and unlawful.
2. On or before 20 days from the date of this order, MidAmerican Energy Company shall file revised tariff sheets that produce total revenue, including a permanent rate increase of \$17,746,034, not to exceed \$699,612,467.
3. The objections of Keith Meyer to the "Settlement Agreement" filed on July 15, 2002, are overruled and denied.
4. The non-unanimous "Settlement Agreement" filed by MidAmerican Energy Company and all other parties, except Keith Meyer, on July 15, 2002, is approved.

5. MidAmerican Energy Company shall file proposed tariffs that eliminates remaining rate disparities between east and west zones with its next permanent rate case application.

7. All motions or objections not specifically ruled on by the Utilities Board in this order or a previous order are overruled and denied.

8. This order constitutes the final decision of the Utilities Board in Docket No. RPU-02-2.

**UTILITIES BOARD**

/s/ Diane Munns

/s/ Mark O. Lambert

ATTEST:

/s/ Sharon Mayer  
Executive Secretary, Assistant to

/s/ Elliott Smith

Dated at Des Moines, Iowa, this 8<sup>th</sup> day of November, 2002.